CAPITAL CRISIS --
REAL OR IMAGINED

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I was pleased to find a question mark in the title of this seminar. For one thing, it suggests that your minds are still open to serious debate on the problems of financial or capital markets and the role they play in this country's investment undertakings. For another, it is not clear that a capital crisis exists. There are capital markets issues which deserve serious attention, and to which we must all be attentive. I do not believe that these issues constitute a crisis, however. This is fortunate, if true, since a crisis atmosphere is hardly suitable for rational decision making.

Capital means different things to different people. To some, it is the stock of physical capital--plant and equipment, housing and inventories. To others, it is financial capital--those assets which facilitate transactions, and which ease the task of doing business. As a result, any two people found discussing the need for capital may be talking about very different things. In my remarks this morning, I shall do my best to keep these issues separate.

Let me begin by considering the prospects for this country's investment in physical capital. Will constraints--environmental, supply or other--hinder the production of physical capital in the near future to keep economic activity indefinitely at a relatively low level? That is, will we produce sufficient physical capital to maintain normal economic growth?

In my view, the answer to the first question is a qualified "No." The qualifications are a recovery that is orderly and a change in the composition of investment that permits us to avoid bottlenecks.

In such a case, productive capacity will not be a problem. Right now, many manufacturing industries are operating well below normal capacity. Such firms will be able to expand output substantially without large additional plant and equipment investment in the near future. It is true that investment by major materials producers--industries which proved to be bottlenecks in 1973--will have to be substantial if these industries are to meet replacement and pollution abatement requirements and to expand capacity as well. There is some evidence that this investment is already underway, and that the task appears to be manageable. Of course, one key variable is economic policy. A controlled return to full employment will permit firms in all industries to expand output and capacity in an orderly manner in an environment less burdened by economic uncertainties and inflationary pressures.

The answer to the second question--can we invest enough to maintain accustomed economic growth--is a qualified "Yes." The qualification here is that it is not at all clear that "normal" economic growth can be our over-riding objective. It is a commonplace by now that there is no free lunch. One cannot have energy conservation, a better protected environment <u>and</u> an increase in the production of goods and services <u>without</u> sacrifices of current consumption or leisure or both. Two things stand out: first, the rise in the price of energy--unless compensated by rising productivity--means a decline in the living standard of a typical American household. Major exceptions to this rule will tend to be found in energy-rich states such as yours, but for the most of society the increase in the price of energy may well bring about a slowing in the pace of economic activity. This means that while we may return to a "normal" rate of economic growth, we will be starting from a shrunken base.

Second, the way in which economic growth is measured is not a trivial matter. Every first-year student of economics is required to learn a basic list of criticisms of gross national product as a measure of human well-being. Chief among these is the fact that gross national product estimates do not capture those things which people value, but which are not traded in the market place. Much of our future investment will be in pollution abatement, the benefits of which are presently given no weight in measures of economic achievement. If this continues, it will be more difficult in the future to maintain accustomed rates of growth as traditionally measured. This would be true even though real human welfare might be increasing quite nicely. Some think this calls for reform of GNP accounting to assign value to such achievement. This is a problem in avoiding delusion, however, not a crisis.

The question of future investment undertakings has been taken up by a wide variety of consulting groups, government agencies and prestigious corporations. I find their answers moderately assuring. With the exception of a study done for the New York Stock Exchange, most students of this problem seem to find that investment in housing, plant and equipment, rapid transit, environmental improvement and whatever else one finds on a standard list of social goals will not place unbearable strain on the economy's productive capacity--at least over the next five years or so.

I would like to interject a comment about the Stock Exchange study. Just over a year ago, the New York Stock Exchange research department published a report in which it estimated that the capital needs of the country would require an investment--in current dollars--of four and one half trillion dollars between 1973 and 1985, and that private savings could fall short of that by six hundred and fifty billion dollars. These are the numbers which have received the greatest attention in the business and popular press, and they are absolutely staggering. The first thing that comes to mind is how on earth can such a task be accomplished? This is the wrong question, however. One's attention is riveted to a problem whose absolute size is almost beyond comprehension, and is diverted from substantive, interesting and manageable questions.

Is 4.5 trillion dollars a lot or a little? It's an enormous sum by any absolute standard, but when put into perspective, it shrinks to understandable proportions. If we assume that 4.5 trillion dollars is needed for investment in the thirteen year period concerned, this means--even with a comparatively low estimate of GNP growth--that 16.4 per cent of gross national product would have to be devoted to gross private domestic investment. How does this compare with past experience? From 1946 to 1974, the United States invested 15.6 per cent of its real total product. In eight of those 29 years, the rate of investment was greater than 16.4 per cent. So although we are talking about very large sums, they are within reason. We are also talking about a very large country and a large and productive economy.

It is not the size of our future investment undertakings which concerns me. I believe our real problems have less to do with our ability to produce and invest whatever individuals think appropriate considering the sacrifices involved, than with our ability to finance these undertakings. Without an efficient market for borrowers and lenders, and a stable and predictable business environment, our chances of hitting our desired rate of investment will be greatly diminished. Allow me to describe a number of specific problems related to financial markets, and to indicate briefly what I consider to be productive courses of action.

Since the late 1950's, there have been dramatic changes in the balance sheets of both financial and nonfinancial corporations. If the assets of nonfinancial corporations are valued at historical prices, we find that from 1946 to 1958, the debt of domestic nonfinancial corporations stayed roughly at 80 per cent of their equity. Then, from 1959 to 1974, debt rose to 129 per cent of equity. This is an increase in the debt-equity ratio of over sixty per cent. Now if assets were valued at current rather than historical cost, the rise would be less dramatic but still impressive. From 1946 to 1958, debt equaled 70 per cent of equity, after which it rose to an all time high of 95 per cent in 1973. This is still an increase of 35 per cent -- a not insignificant amount.

Also, the liquidity of domestic nonfinancial corporations has fallen. In 1950, liquid assets were 59 per cent of short-term liabilities. By 1974, they had fallen to 23 per cent of short-term liabilities. All in all, in the last decade, there has been a marked increase in corporations' reliance on external markets to finance their investment undertakings. Debt financing has grown relative to increases in equity. Also, short-term borrowing has become a significant source of funds in the last two years.

Financial corporations have done no better in this regard. At the end of 1960, the capital accounts of insured commercial banks were equal to 15.9 per cent of their risk assets. By the end of 1974, this figure had fallen to 9.2 per cent. Over the same period, the price-earnings ratios of commercial banks fell by roughly 65 per cent.

Before going on, let me just note that in 1975 these trends have been reversed. For nonfinancial corporations, internal funds generation has improved and reliance on short-term debt has been reduced. Whether balance sheet improvement will continue is another matter. For the moment, however, it seems as if most companies are trying to improve their balance sheets.

Also, I am extremely pleased to find that banks seem to be improving their capitalization. According to data from the reports of condition for all commercial banks, bank capital rose to 9.7 per cent of risk assets by the end of June, 1975. This trend is continuing for the more than 300 large banks which report to us every week, and although the data are not available, it would be logical to assume that the smaller banks are following suit.

I am particularly encouraged by this apparent turnaround since banks will have an exceptionally important role to play in the recovery and future expansion. Banks have been called department stores for credit, and the designation is appropriate. As such, they should prove to be the primary source of credit for companies which are either too small or too new to receive the serious attention of nonbank investors.

Now, it is easy to understand why there has been an increasing reliance on debt. For one thing, until very recently, interest rates have not fully reflected price level changes. If a company can borrow money at five per cent when prices are rising at five per cent, the effective interest rate is zero. Under these circumstances, a profit maximizing strategy would dictate more borrowing and less equity financing.

For another thing, the tax status of interest payments is not the same as the tax status of dividends and retained earnings. Since interest expenses are tax deductible while dividends are not, debt financing is relatively more attractive than equity financing. I should point out, also, that the distortion in favor of debt over equity financing is aggravated during periods of rising prices. The effective return on investment that a company must earn to justify selling stock rises dramatically relative to the earnings necessary for servicing debt payments.

It is one thing to understand the reasons for the trend for debt financing and to see that it is not inconsistent with a profit maximizing strategy. It nevertheless raises questions. A rising debt-equity ratio reduces a company's ability to withstand shock, a weakening which is aggravated by an increased dependence on short-term debt. In recent years, bond ratings were reduced in many instances, and the market value of equity in nonfinancial corporations fell below the adjusted book value. It seems that neither equity holders nor bond holders have found corporate balance sheets to be very attractive.

I think things need to be done with respect to this problem. The first is to change our tax and accounting practices to eliminate the unequal tax status of interest payments, dividends and retained earnings and to eliminate the distortions in corporate earnings which arise during a period of rising prices. The second is to pursue a monetary policy which will bring about stable prices and minimize distortions in financial markets. Together, these steps would go a long way toward curing corporate financial problems.

Still another major problem which we must confront is the relationship between public borrowing and the supply of savings to private investors. It is widely thought that every dollar borrowed by the Federal Government from the private sector, reduces by almost a dollar the supply of private savings to private investors. Whether this is true has important implications for the conduct of monetary and fiscal policy.

I have two comments on this subject. First, it is important to know by how much public borrowing reduces the rate of real private investment. If there is truly a "crowding out" in this situation--and I stress if--the large Federal budget deficits which seem to be in the offing will pose a problem for the Federal Reserve System.

Consider the situation if such a trade-off between public borrowing and private investment exists. A large Federal deficit forces a choice among several undesirable options. Continued principal emphasis on a goal of stable prices could, depending on circumstances,make the Federal deficit depress the rate of private investment. Or, the effect of the deficit on private investment could be dampened for a short time by monetizing part or all of the debt. I must emphasize, however, that electing to monetize the debt carries with it the long-run cost of rising rates of inflation and higher interest rates. Since our economy does not appear to function well during periods of inflation, this course could only cause us trouble in the future.

As I noted, it is important to policy makers to know whether this widely accepted relationship between government borrowing and private investment actually exists. What is particularly surprising about this issue is that apparently little effort has been devoted to finding the empirical relationship between the government deficit and private investment.

The issue here is how the private sector perceives current Federal deficit spending in relation to their future tax liability. For example, a tax cut which is financed by increased government borrowing does not by itself increase the private sector's claim over real goods and services. Therefore, if households and corporations recognize this, a simple debt-financed tax cut would not cause much of an increase in consumption expenditures. In the most extreme case, since their real claim over resources is unchanged, they would continue to consume at the same rate and increase their savings by the amount of the tax cut. They would, in other words, simply add the deficit to their original savings. Hence the supply of private savings to private investors would be undiminished.

Whether the private sector actually behaves this way is a factual issue. That is, one should observe higher rates of private savings when the government is in deficit than when it is in surplus. Now the evidence is rudimentary to be certain, but it does seem to indicate that private capital accumulation is not greatly affected by the way the Federal Government chooses to finance its real expenditures. In the United States, households tend to consume less and save more out of disposable income when the government is borrowing. Also, if you compare the personal savings rates of the world's major industrial countries for the three-year period, 1964 through 1966, with the savings rates for the three-year period, 1972 through 1974, you will find a marked increase since the deficits were typically greater during the latter period. It is conceivable that what we are observing is a tendency for the private sector to save the deficit.

Before leaving this subject, let me say that I do not know where the truth lies. What little evidence does exist suggests that this is a problem for serious and open-minded consideration. There may or may not prove to be a "crowding out" problem with large Federal deficits. However, enlightenment does not come from accepting conventional wisdom as gospel.

A third major problem arises from the inflexibility of existing financial institutions. Part of this is due to regulation, part is due to an apparent unwillingness of borrowers and lenders to write flexible contracts. I have believed for some time that controls on interest rate payments by depository institutions do not promote efficiency in financial markets. Rather, such controls have tended to cause unnecessary instability during the recent periods of inflation. While in the short-run, interest rate ceilings may be required to aid in financing residential construction, it is in the long-run interest of the country to remove these regulations. In fact, the Federal Reserve Board has suggested doing so, in phased steps.

In the same vein, I believe that greater attention should be given to the benefits and costs of more widespread use of flexible contracts for borrowers and lenders. For example, long-term mortgages bearing fixed rates of interest do not work optimally during prolonged periods of unanticipated or unpredictable inflation or deflation.

A carefully structured variable interest rate mortgage, or a mortgage loan whose principal balance is adjusted for changes in a suitable price index, might better insulate many borrowers and lenders against price level changes, and to this extent permit them to concentrate more on real economic variables.

A fourth problem is this. You are all aware of an increasing concern about loan quality. I view this as a healthy change in attitude. But it must be balanced against the banking system's primary duty to provide financing for the public's needs. There need be no extreme aversion to the normal risk-taking role of banking simply because risk-taking went too far in the recent past. The economic health of our country requires a willingness to take a chance on new ideas and new enterprises without being reckless. If closer attention to loan quality means a more rational evaluation of the promise of an investment, I am all for it. If it means nothing more than a pathological avoidance of risk, however, I am opposed to it. I am happy to have the go-go years behind us, but I also hope that that experience has not created a new generation of depression loan officers.

A fifth major problem, one which I have already touched on briefly, and the last one I shall consider this morning, is the importance of aiming both fiscal and monetary policy at increased price stability. It seems apparent that our financial markets do not behave well during periods of inflation. They do work, however, when prices are stable. Therefore, while we should attempt to make financial institutions as flexible as possible, we must also pursue price stability, and you can be sure that we shall.

Let me summarize briefly. I do not believe that the United States is faced with a capital crisis. We must, however, choose our course of action with care. We must be concerned with the financial condition of our corporations, and take whatever steps we can to enhance their ability to increase their equity capital. This will require change in the tax law and in regulations. At the same time, we must increase the flexibility of depository institutions. As for macroeconomic policy, it seems clear that more than anything else the economy will require policy actions which are both stable and predictable if we are to reduce inflationary pressures as well as recover surely and smoothly from the current recession.